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In the Supreme Court of the United States

OCTOBER TERM, 1985

ROBERT B. PAYNE, INDEPENDENT EXECUTOR OF THE ESTATE OF NELLIE S. JOHNSTON, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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Petitioner challenges the court of appeals' holding that a portion of the royalty payments received by the decedent's estate between the date of her death and the alternate valuation date authorized by Section 2032(a) of the Internal Revenue Code is includable in the gross estate for purposes of determining federal estate tax. The decision of the court of appeals is correct. Petitioner does not allege, nor is there, a conflict among the circuits on the question presented. There is no reason for review by this Court.

1. Nellie Johnston (decedent) died on January 27, 1974, leaving a will in which petitioner Robert Payne was nominated executor. Pursuant to Section 2032(a) of the Code,[1]

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[1]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U S.C.), as amended (the Code or I.R.C.).

petitioner elected to value her gross estate on the alternate or optional valuation date, *i.e.*, six months after death, rather than at the date of death.[2] At the time of her death, decedent owned royalty and working interests in numerous oil and gas properties. During the six-month period between her death and the alternate valuation date, these various oil and gas interests generated net proceeds of $156,011 (net production proceeds).[3] Petitioner paid income tax on that amount after deducting therefrom an allowance for depletion pursuant to Section 611 of the Code. He did not include any portion of these proceeds in the value of the gross estate for estate tax purposes (Pet. App. A3).

Both the language of the predecessor of Section 2032(a) (see Revenue Act of 1935, ch. 829, § 202, 49 Stat. 1014), and the Treasury regulations in effect at the time of decedent's death (Treas. Reg. § 20.2032-1(a) (1974) (reprinted in pertinent part at Pet. App. A4-A5 nn.5, 6)), emphasized that, regardless of which valuation date is selected, the assets to be valued for estate tax purposes are the same, viz., the assets includable in the estate at the date of death. Those regulations draw a distinction between assets held on the date of death, which are termed "included property," and income subsequently generated by the assets, which is termed "excluded property." Of particular importance to this case is the portion of the regulation that provides that

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[2]Section 2001 of the Code imposes a tax "on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States." Although the value of the gross estate is generally determined by aggregating the values of all the decedent's property interests as of the date of death (I.R.C. §§ 2031, 2033), the executor may elect pursuant to Section 2032(a) to value the decedent's property on a date six months after death, or as of the date of any property's disposition if it is disposed of within the six-month period.

[3]The net production proceeds were calculated by subtracting operating expenses, severance taxes, and overhead costs from the gross proceeds derived from the estate's oil and gas interests.

all property interests existing at the date of decedent's death "remain 'included property' for the purpose of valuing the gross estate under the alternate valuation method even though they change in form during the alternate valuation period by being actually received, or disposed of, in whole or in part, by the estate." Treas. Reg. § 20.2032-1(d). An executor thus is prevented from converting various estate assets into another form (most commonly, cash) and then characterizing the "new" property as post-death income not subject to estate tax.

Pursuant to this regulation, the Commissioner of Internal Revenue, on audit of the estate tax return, determined that the net production proceeds should be included in decedent's gross estate as representing a portion of the estate's oil and gas property that had been sold prior to the alternate valuation date and converted into cash. Petitioner paid the deficiency and, following the denial of his administrative claim for refund, brought this refund action in the United States District Court for the Northern District of Texas. He contended, inter alia, that the inclusion of any part of the net production proceeds in the gross estate was erroneous. Pet. App. A3-A4.

On cross-motions for summary judgment, the district court entered judgment for petitioner (Pet. App. C1-C15). Relying primarily on *Maass* v. *Higgins*, 312 U.S. 443 (1941), the district court held that no portion of the net production proceeds was includable in the gross estate because such proceeds had been severed from the estate prior to the alternate valuation date and had been treated as income to the estate for income tax purposes (Pet. App. C10-C14). In so holding, the district court rejected Rev. Rul. 71-317, 1971-2 C.B. 328, and Rev. Rul. 66-348, 1966-2 C.B. 433, which had held to the contrary (see Pet. App. C7-C9).

The court of appeals unanimously reversed (Pet. App. A1-A11). The court explained (*id.* at A7) that the district court had misinterpreted *Maass*:

> We perceive *Maass* as directing a review of each case on its own facts, with an eye toward determining the common understanding whether the proceeds in question truly represent income produced by the estate or, rather, are the translation of the corpus of the estate into another form. The former would not be included in the estate tax inventory, the latter would.

Applying the foregoing analysis, the court of appeals first stressed that, unlike stocks, bonds, or rental property, mineral interests are wasting assets that generate income only when a portion of the mineral reserves they encompass is depleted (Pet. App. A7). Accordingly, royalty payments represent in part a return of capital, a fact that Congress has recognized in providing a deduction for depletion (*id.* at A7-A8). The controlling principle of federal estate taxation, the court emphasized, is that "the contents of the estate are fixed as of the moment of the decedent's demise" (*id.* at A6). As applied to this case, the court held, that principle led inevitably to the conclusion that, where a portion of the reserves owned by the estate on the date of death are removed during the alternate valuation period, the reserves held on the date of death, including those removed, must be valued for estate tax purposes. "The *quantity* of the reserves are determined as of the date of the decedent's death; only the *value* to be assigned to that quantity of reserves may be changed by market variances when severed before the alternate valuation date" (*id.* at A9 (emphasis added)). The court remanded the case to the district court for a determination

of the in-place value of the oil and gas produced by or on behalf of the estate during the alternate valuation period.[4]

2. The court of appeals correctly rejected petitioner's contention (Pet. 3-8) that the return-of-capital component of the royalties received between the date of death and the alternate valuation date should be excluded from the gross estate. It is undisputed that the Code fixes the contents of the gross estate as of the moment of death, regardless of which valuation date is selected. Thus, as the regulations stress, the assets included in the estate at the time of death remain a part thereof "even though they change in form" during the six months prior to the alternate valuation date. Treas. Reg. *§* 20.2032-1(d). Here, the oil and gas payments received by the estate during the interim period—to the extent that they represented a return of capital—represented a change in the *form* of estate assets from in-place oil and gas reserves to money. This direct correlation between oil and gas payments and depletion of the mineral assets is reflected in the Code's special depletion allowances. See I.R.C. *§§* 611-617; see also note 4, *infra*. Therefore, the capital portion of the royalty payments must be taken into account in determining the gross estate. Otherwise, the estate would be permitted to use the alternate valuation period as a grace period in which to transfer property out of the estate and thereby avoid paying estate tax on it. This was not the intent of Congress in enacting Section 2032.[5]

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[4]In remanding the case for purposes of making this computation, the court of appeals rejected the view embodied in Rev. Rul. 71-317 that the value of the interim-period production to be included in the gross estate should be computed by applying a discount factor to the amount of the proceeds.

[5]Section 2032 was enacted during the Great Depression to mitigate the hardship that results when the value of a decedent's assets decreases materially between the date of death and the date of distribution to the beneficiaries. See 79 Cong. Rec. 14632 (1935); S. Rep. 1240, 74th Cong.,

3. Petitioner asserts (Pet. 4-8) that the decision below conflicts with three of this Court's decisions, *Maass* v. *Higgins*, 312 U.S. 443 (1941), *Anderson* v. *Helvering*, 310 U.S. 404 (1939), and *Bull* v. *United States*, 295 U.S. 247 (1935). To the contrary, each of these cases is fully consistent with the court of appeals' holding.

a. In *Maass*, the Court invalidated a Treasury regulation that had required the inclusion in the gross estate of virtually any type of income—including rents, interest and dividends—received by an estate during the interim period. *Maass* carefully distinguished between assets held at death and income subsequently derived therefrom; the Court's ruling was that the latter should not be included in the gross estate. Both Treas. Reg. § 20.2032-1(d) and the court of appeals' decision in this case draw precisely the same distinction. This case is unlike *Maass* because it involves a wasting asset, with the result that part of the royalty payments received by the estate during the interim period are directly attributable to the sale of the underlying assets. In these circumstances, the *Maass* decision, far from supporting petitioner's position, requires that the portion of the net production proceeds representing a return of capital be included in the gross estate.[6]

1st Sess. 9 (1935). As the court of appeals explained (Pet. App. A9), this legislative purpose obviously is not defeated by refusing to permit an estate to reduce its tax liability by disposing of estate assets.

[6]Petitioner acknowledges (Pet. 5) that the Court in *Maass* did not deal with oil-and-gas royalty income, but restricted its discussion to interim interest, dividends and rent. His position is that royalties are indistinguishable from rents and interest. But that is plainly not so: Congress explicitly recognized the dual nature of royalty payments, *i.e.*, income and return of capital, by providing the holders of economic interests in minerals a deduction for depletion. This Court on several occasions has explained that the depletion deduction represents a return of the capital consumed in the production of income by means of severing mineral units. See, *e.g.*, *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 312 (1956); *Palmer* v. *Bender*, 287 U.S. 551, 557-558 (1933). See also *Commissioner* v. *Engle*, 464 U.S. 206, 209 (1984).

b. *Anderson* v. *Helvering, supra*, is completely inapposite. That was an income tax case raising the question whether certain oil production proceeds that were assigned by the purchaser of an oil and gas property to the seller thereof were includable in the purchaser's income. To the extent it bears on the question here, the rationale of *Anderson* supports the decision below. The Court in *Anderson* acknowledged that proceeds from the sale of extracted minerals are subject to ordinary income rather than capital gain treatment. But this conclusion derived from the holding of *Burnet* v. *Harmel*, 287 U.S. 103, 105-107 (1932), that such proceeds do not result from a "sale or exchange" within the meaning of the Code's capital gain provisions. See 310 U.S. at 407-408; I.R.C. §§ 1202, 1221. Contrary to petitioner's contention (Pet. 5-6), therefore, *Anderson* suggested no divergence from the well-established principle that the production of oil and gas constitutes the conversion of a capital asset. Indeed, the Court in *Anderson* specifically recognized that the owner of a mineral interest is granted a depletion deduction "as compensation for the capital assets consumed in the production of income through the severance of the minerals" (310 U.S. at 408).[7]

c. Petitioner relies (Pet. 7-8) on *Bull* v. *United States, supra*, for the proposition that the same receipt cannot simultaneously be treated as both income and corpus and

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[7]Petitioner challenges (Pet. 6) the court of appeals' statement that the estate possessed oil and gas reserves, arguing instead that it merely held interests in "oil and gas properties." To the extent that this semantic point is of any significance, this Court has stated that the owner of a royalty interest has "an economic interest in the [mineral], in place." *Palmer* v. *Bender*, 287 U.S. 551, 557 (1933). See also *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. at 316 ("Their income was dependent entirely on production, and the value of their interest decreased with each barrel of oil produced."). Indeed, petitioner's position on this point is difficult to square with the estate's own income tax return, in which it took depletion deductions that necessarily were premised upon its having an "economic interest" in actual mineral deposits. See Treas. Reg. § 1.611-1(b).

thereby be subjected to "double taxation" under the federal income and estate tax laws. But the decision below countenances no "double taxation." That decision requires that the net production proceeds be allocated between corpus (the in-place value of the minerals extracted) and income. The former is subject to the estate tax; the latter is subject to the income tax. Any potential "double taxation" of the net production proceeds is precluded by the allowance for income tax purposes of the deduction for depletion, through which the value of the minerals included in the estate—that is, the return-of-capital component—will eventually be recovered tax-free. See *A. Duda & Sons, Inc.* v. *United States*, 560 F.2d 669, 673 (5th Cir. 1977); Rev. Rul. 66-348, 1966-2 C.B. 433 (permitting an estate to increase its depletable basis in its mineral interest by the value of interim production included in the gross estate).[8]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FRIED
Solicitor General

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[8]As the court of appeals explained (Pet. App. A10), the fallacy of petitioner's argument is apparent from examination of the treatment of royalties received outside the interim period. For example, a portion of the oil and gas payments received after the alternate valuation date would be subject to income tax even though the in-place value of the extracted minerals had been included in the gross estate and subjected to estate tax. This is not any impermissible sort of "double taxation"; it simply reflects the fact that Congress has imposed two distinct taxes—the income tax and the estate tax—each with a different subject and with a different temporal focus.